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PROBLEMS OF THE DIVISION OF FUNCTIONS AND SOURCES
OF REVENUE AND PROBLEMS OF ECONOMIC CO-ORDINATION
IN A FEDERAL COUNTRY

REPORT SUBMITTED TO THE
ROYAL COMMISSION ON BILINGUALISM AND BICULTURALISM

A.M. Moore
January 1966

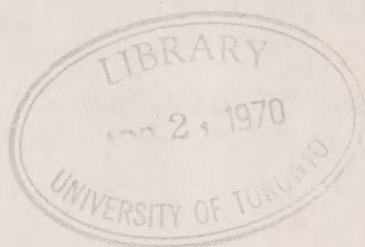


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Chapter 1

SOME PROBLEMS OF THE DIVISION OF FUNCTIONS AND REVENUE SOURCES IN A FEDERAL COUNTRY

In recent years there has been considerable writing and a growing preoccupation by economists with the special problems of federal finance. And it has been suggested that federal-provincial financial relations are a special case of a larger family which includes provincial-municipal relations, tariff unions such as the E.E.C. and E.F.T.A. and also such half-way situations as pertain to the government of Northern Ireland, for example. The common characteristic distinguished is that the entities making up the political unit retain some measure of independence and sovereignty while, in each case, freedom of action concerning some economic functions is surrendered. Provincial-municipal relations may therefore not be thought to be properly classified under the general head of 'problems of federalism' since the municipalities are the creatures of the provinces and possess no sovereignty de jure. However, their long possession of independence, de facto, with respect to some functions makes it politically difficult to deprive them of these powers and the successful implementation of some provincial programs requires the exercise of initiative by the municipalities. Some problems of the division of functions and revenue sources are, therefore, common to all the entities mentioned.

Since the distribution of functions and the consequent problems of co-ordination are the distinguishing characteristics, it is clear that the analysis relates to the relations between units of government - not to individuals. On reflection, therefore, it might appear that the

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Since the division of functions and the consequent problem of coordination are the distinguishing characteristics, it is clear that the analysis referred to the relations between units of Government - and to individuals. On reflection, however, it might appear that the

economist can hope to have very little to contribute to the resolution of these essentially political problems. 'Positive economics' has always been confined to the analysis of the behaviour of the firm and industry and the individual and family - taking the actions of governments as givens or constraints. Similarly, the basis of welfare economics is the individual or family and the starting point must be some given, basic value judgments, presumably arrived at politically.

The analysis of the economics of federalism is normative. This is shown by the nature of the questions posed, such as: how can the policies of two levels of government be co-ordinated? It is possible for economic analysis to be brought to bear upon these problems by way of what is sometimes called 'normative management'. That is, given the institutional conditions, it is possible to say: to attain such and such policy objectives, the best measures to adopt in such and such conditions are so and so. But, in the end, what the economist finds himself recommending regarding the joint action of two levels of government are the same prescriptions as those given for the actions of a unitary country in the same circumstances. This normative management approach, therefore, can hardly lead to a 'general theory' of federalism - just as it would be grandiose to talk of a general theory of customs unions since that theory is only an application of the theory of international trade to specified circumstances.

The point to be made is that economics has little to offer concerning a theory of the relations between governments. Economic analysis can be brought to bear upon specific policy problems in the limited way mentioned: in given conditions, given measures are likely

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to realise the specified goals. But the identification of the techniques which are most likely to achieve successful co-ordination is an exercise in judgment concerning which the economist writes as a layman, informed in only one of the relevant disciplines - a layman who wanders into the realm of public administration and political science. Accordingly, the intent of this monograph is limited to a general discussion of the 'standard' problems of government finance in a federal country and a discussion of some of the techniques which can be employed to co-ordinate the economic programs of the two levels of government.

The appendix to this chapter summarizes the tax agreements and like developments in Canada. The chapter itself attempts a 'standard' analytical exposition of the division of functions and sources of revenue; that is, it follows a fairly orthodox treatment.

There are three what might be called 'technical financial' aspects of federalism. That is to say there are three technical fiscal problems which do not face a unitary country but have to be solved by a federal nation. And the resolution of these problems imposes strains and gives rise to divisive currents which are self-perpetuating. Conversely, of course, it can be argued that the absence of divided jurisdiction which recognises the diversity of the provinces would impose even greater strains upon unity.

The technical fiscal problems are:

- (a) the division of expenditure functions between the two levels of government;
- (b) the division of revenue sources commensurate with the division of expenditure functions; and it is clear that the division of revenues can either thwart or facilitate the realisation of the division of functions which may be taken to be agreed upon or acquiesced in at a particular time; and,
- (c) the recognition of the unequal fiscal capacities and fiscal needs of the various provinces. An agreed division of sources of revenue carries with it, inevitably, some implicit recognition of unequal fiscal capacity and need.

1. The Division of Expenditure Functions

Obviously, the division of functions comprises the substance of co-operative, or any other variant, of federalism. A resolution of the other two technical fiscal problems is derivative from and must be accommodated to the agreed division of functions.

To follow an 'efficiency' approach one asks the question: which level is better situated to perform the function? Actually this is a point of departure which is not very fruitful except in a negative way because it is most unlikely that the division of functions will be determined according to the level which is best situated and equipped to perform them. Even if this were the basis for the original division of functions, it is even more unlikely that the arrangements will be adjusted periodically in keeping with changing conditions.

It can be argued that the federal government can perform most economic functions more efficiently than the provinces even given equal competence and financial resources because sheer size confers an advantage. On the other hand, the close acquaintance of a provincial department with the peculiar problems of the region and the probability that most provincial departments are large enough to approach optimum size, weigh in favour of the provincial departments being theoretically the equal in efficiency to the federal. The economies of scale in research, of course, extend far beyond the size of even the largest provincial departments but this deficiency can be overcome by a division of labor among them (though such a high degree of co-operation is not very likely). Accordingly, the strongest argument weighing in favour of the superiority of performance of a single federal department over

several provincial ones is that the necessity for the existence of machinery for arranging a division of labor and for the co-ordination of activities which may lead to conflict, is avoided.

The rationale for the existence of certain federal departments in certain spheres of provincial jurisdiction may reflect this need for co-ordination. The justifications for a federal department of forestry, for example, presumably are: (a) that the provincial forestry policies need to be co-ordinated; (b) that some of the provincial forestry departments may neglect some tasks some of the time and the federal department can make up for these deficiencies; and (c) that a country must have a federal department or branch which can be the liaison office with other countries and with international organizations concerning forestry matters. Provincial forestry matters may need to be co-ordinated if the action or inaction of one province has a detrimental effect upon the welfare of residents in another province; or, if concerted action is needed to solve a common problem. An example of the former could be the failure to control an insect or disease infestation. A province might recognise that the control of the infestation was important and it might recognise the interests of adjoining provinces but still decide possibly with justification, that it could not afford a control program because other expenditures demanded greater priority. The federal government can solve such difficulties by footing the bill (which indirectly means that it is substituting its priorities for those of the province in question). Similarly, if concerted action by two or more provinces is required to solve a common problem, e.g. pollution of an inter-provincial river, the mutual interest ought to

give rise to co-ordinated action in the absence of federal initiative. But it does not always do so and a federal shared-cost program can improve performance (again, priorities among expenditures is involved).

Analogous reasoning applies to other 'engineering' functions of government: highways, power development, research and the like.

But the matters of pressing current interest are not these functions but the overall economic policies of the nation and their co-ordination. It is with respect to these functions that there may be some misconceptions. The justification for an over-riding federal responsibility is not to be found in the superior federal efficiency. The justification is the continued unity of the country. Let us first consider monetary policy.

Monetary policy is an engineering function. It consists of adjusting the cost and availability of loan funds appropriately to the circumstances of the period. This is precisely why, under ideal conditions, five monetary authorities would be more efficient than one. When aggregate demand in Ontario is tending to become excessive it is desirable that monetary restraints be imposed to reduce the ensuing inflation. But it has been observed that inflationary pressures have been present in Central Canada when aggregate demand was inadequate in the Atlantic Provinces and even British Columbia. Accordingly, ideally, interest rates should be allowed to rise in Central Canada while they were pushed down in the Atlantic Provinces and British Columbia. But when there is a single currency this is not possible because borrowers in all parts of the country are free to seek out the lowest cost funds. Even when there are different

currencies, the power to pursue autonomous monetary policies is circumscribed to greater or less degree depending upon the institutions and controls utilised. With different currencies, two or more monetary policies going in different directions at a given time may nor may not be feasible; with a single currency, they are not. Hence, the most efficient monetary management requires that there be a different currency for each region but a single currency is one of the few common symbols we have and to abandon it would be to weaken the sense of unity.

Approximately analogous reasoning applies to fiscal policy - the running of deficits and surpluses and the management of the national debt. Measures appropriate to the conditions of the greater part of the country are unlikely to be precisely right for the conditions of each of the regions. The conflict of interests among the regions is sharper in matters of commercial policy such as the tariff. Because the interests of the regions are in conflict, it has been thought that the national interest required that the federal government be sovereign in this function.

The second major consideration which has been frequently urged as important, and in some instances decisive, for the division of functions between the federal and provincial levels of government, is the implementation of democratic government. Since the governments closest to the people are thought to be the most responsive to their desires, it is advocated that all functions which can be performed by the provinces almost as efficiently as the federal government, should be performed by the former. To get the best of both worlds, it has also been advocated that the federal government retain the power to

intervene by using conditional grants or shared-cost programs, to repair the neglect of some functions by some provinces and counter provincial procrastination in the implementation of the public's wishes for the adoption of new public expenditure programs, particularly in the field of welfare.

This is a matter which cannot be resolved; one can form only subjective judgments. It can be argued that federal governments sometimes show themselves to be more responsive to and more aware of the public's wishes than are the majority of provincial or state governments. It can also be argued that, if this is the decisive consideration, certain provincial functions ought to be performed by municipal governments of a viable size rather than by the provinces.

A third consideration which is of great importance for the allocation of functions between the federal and provincial governments, is sometimes overlooked. This is that a country may lose its sense of unity and identity if all or most of the functions of greatest concern to the public are performed by regional governments. If it is to the provinces that the public must look for action which enables them to achieve their aspirations and for the ushering in of the good society to which we are presumably committed, one might well wonder how a national identity can be achieved and, if achieved, maintained. Wars create national identities because they are national endeavours.

The fourth aspect of the division of functions between the two sovereign levels of government concerns the differences in aspirations and cultural environment of the provinces. This is the 'standard' explanation of Canadian federalism, sanctified by the Rowell-Sirois Report. Since there is diversity among unity, some

functions, notably education, it is said, must be accorded to the provinces. Such diversity was easy to discern in earlier decades. The role of the church in welfare and education in Quebec differed significantly from that in other provinces, for example, and so did the philosophy concerning these matters. In the present decade, however, identification of the diversity is more difficult. If one runs down the list of government functions, one is hard put to find any - with the possible exception of international relations - concerning which the wishes, aspirations and preferences of the public in different provinces diverge greatly in respect to public expenditure programs. It appears that the majority of the residents of all provinces now want the same kind and quality of primary and secondary education, for example, and all endorse the principle of a substantial equality in educational opportunity. And it may be that the majority in every province except Newfoundland want education to be secular and not sectarian. The quiet revolution in Quebec appears to have ended the sharp cleavage in the concepts of the proper role of the state formerly attributable to different cultural environments.

This leaves us with the different cultural environments themselves. Do they imply federalism? At first blush one is inclined to think so. On reflection, however, one wonders why federalism is required to ensure, for example, that primary and secondary education be conducted in two languages.

The final consideration which is relevant to the division of functions between the federal and provincial governments may often be decisive. This is that there exists more than one national identity. A sense of separate identity and the existence of conflicting interests

may be incompatible with a unitary government. The conflicts of interest do not necessarily relate primarily to the major economic policies of the nation such as those undertaken to maintain a high and stable level of income and employment and a satisfactory rate of economic growth without inflation. An example of such a cultural conflict, in the case of Canada, is whether French or English is to be the language of commerce and industry in Quebec and whether a fluent command of English and membership in an English cultural community during working hours is to be a necessary condition for a successful career in business or the federal government.

Moreover, where there exist more than one national identity, the government of the province or region is likely to want to administer more functions than is the case when all regions are homogeneous. A single, federal government program for regional economic development may be quite suitable for Australia, for example, while it is equally appropriate that these matters be administered by a Scottish Office with the co-operation and financial assistance of the Government of the United Kingdom. In the instance of the resurgence of a sense of separate identity in Quebec, the provincial administration of a maximum number of functions may become an end in itself.

2. Problems of Revenues Commensurate with Expenditure Functions

The conflicts inherent in the financial arrangements of a federal country stem from the division of functions and relate to expenditure priorities. At root, the conflicts of interest concern the facilitation or obstruction of the desired division of functions, particularly the ability of the provinces to implement their expenditure programs, and therefore concern the priorities to be accorded to different expenditure programs.

It is said, for example, that in the decade 1949 to 1958 the provinces were hampered in their pursuit of their expenditure objectives by the largeness of the share of total revenues which the federal government had appropriated. More highways might have been built, more expenditures made to hasten economic development, more funds spent on education and more progress made by some provinces to achieve their desired 'integrated, comprehensive welfare programs' - if federal taxes had been lower so that it would have been possible for the provinces to raise more revenue without having to raise the combined federal-provincial tax rates. The extent to which the provinces would have spent more money in these circumstances is, of course, not known. But that the federal government can confine provincial expenditures to a smaller magnitude by pre-empting tax fields is beyond challenge. There is much talk of nebulous economic and political ceilings to the weight of taxation. In the view of most economists, the economic ceiling is very high - much higher than indicated by the alleged 25 per cent of national income "plimsole line" which was so widely discussed some years ago.

Therefore, political considerations and the various forms of taxpayer resistance to higher taxation set the upper limit. Provincial premiers have apparently considered that they bumped against this upper limit from time to time. It has also been contended that, of the two levels of government, the federal is the more disposed to push up the level of total taxation although at least a mild national crisis of some sort is required to make it politically feasible to impose a large, abrupt increase in total taxes.

On this interpretation, the conflicts over sharing tax fields are really conflicts over expenditure priorities. And so long as the federal government retains revenue sources such that its revenues increase over the years more rapidly than its expenditures on established programs, it will periodically be in a position either to lower tax rates or to introduce new expenditure programs. This was the position which the federal government enjoyed from 1946 to 1957; the balance of payments crisis of 1947 and the Korean war period were exceptions of short duration. In contrast, the provinces and municipalities were in relatively tight financial positions in the sense that the expenditure ambitions of most outran the increase the yields of the existing sets of tax rates. To spend more, they had to raise tax rates, notably of the retail sales taxes, and to incur quite large debts.

It is obvious, then, that whenever it is possible to attain a meeting of minds, agreement should first be reached about the division of functions. Then the division of revenue sources can be made to suit.

Many inequities and technical problems of administration can arise in the absence of agreement among the provinces and between the provinces and the federal government concerning uniform formulae for calculating the amount of corporation profits and personal income deemed to originate in the various provinces, the situs of property taxed by the succession duties, and the like. But these problems have been resolved; agreement has been achieved. Indeed, it is one of the substantial achievements of the tax rental and tax collection agreements that the conflict and overlapping of tax legislation which marks much of the United States tax structure is almost completely absent in Canada.

Since the rates of increase in the yields of various forms of taxation and the rates of increase of expenditures of various programs are unequal and the relative size of federal and provincial-municipal expenditure responsibilities are subject to change, any division of revenue sources between the two levels of government which is technically efficient and compatible with the division of expenditure responsibilities in one period will remain so only by coincidence for a subsequent period. There are therefore two areas in which any federation should be co-operative: the periodic readjustments of expenditure responsibilities and the periodic adjustments of revenue sources. Rather than being a complete misfortune, therefore, the joint use of a single form of taxation - the income taxes in the Canadian case - may be viewed as an arrangement which lends flexibility to the fiscal system. As provincial-municipal expenditure responsibilities rise in relation to those of the federal government, it is appropriate that the former's share of the income taxes increase

commensurately, and vice versa. Such easy flexibility is understandably viewed with some alarm by the federal government on occasion, it being expected that the provincial share of the field, once enlarged, may never again be contracted in the absence of an acute national emergency. While such a fear or expectation is doubtless well grounded, surely the risk must be run. Fiscal arrangements cannot be adjusted to meet current conditions and problems if they must forever be held in a state of preparedness for a national emergency which might occur - such as a severe depression. Realism dictates an act of faith. This is that, whenever a national crisis does emerge agreement can be reached to suspend normal arrangements in order that the federal government may take command of total operations to meet the emergency. The 1947 tax agreements were framed on the expectation that a severe postwar recession would set in. The arsenal of weapons to combat it, as conceived in the proposals of the federal government to the Conference on Reconstruction, were to be kept at the ready. But it was quickly evident that this was not feasible. It proved impractical, for example, to maintain a shelf of public works which could be quickly started when the signal was received. Fiscal arrangements simply cannot be kept simultaneously in a state of emergency readiness and adjusted to normal conditions.

There is another ground for the reluctance of the federal government to reduce its claims upon the income taxes. This is that it realises that its strong revenue position is its greatest bargaining point whenever it wishes to take the initiative in developing new, national expenditure programs. And it has been asserted that this is an important, indeed crucial, condition for the maintenance of the national identity.

Elsewhere we shall discuss in general terms the problems of co-ordinating fiscal policy in a co-operative federalism. In the present context, however, it is convenient to point out that the federal government decision to give up its near-monopoly of the personal income tax was unfortunate for the efficiency of fiscal policy. The retreat has taken two forms. the 'provincial share' of the personal income tax has been enlarged to 24 per cent of the yield of the standard rates effective in 1966; and, the revenue accorded to Quebec in compensation for foregoing conditional grants in the programs from which she has 'opted-out' has taken the form of a percentage of the yield of the personal income tax on income originating in Quebec. It would have been preferable that the provincial share of the income taxes and the quid pro quo under opting-out should have been increased portions of the corporation income tax. The reason for this preference is that varying the weight of the corporate tax is not a useful tool of counter-cyclical fiscal policy. Corporation investment spending is not responsive to changes in the tax. The result is that the only tax which is effective and free of serious defects as a counter-cyclical instrument, is the personal income tax. If Canada is to have a fiscal policy capable of quick adjustment to changes in economic conditions of short duration, therefore, the federal government must be in command of the personal income tax.

3. Unequal Fiscal Capacities and Needs

What constitutes a nation? In answer, some would point to political, legal and constitutional forms; a political unit is a nation if there is a government which is sovereign in certain vital fields such as foreign affairs. Some might say that a country is one nation if there is a sufficient sense of unity; if most residents give their primary allegiance to the government and no substantial, cohesive minority withholds that allegiance. Some would say that a nation constitutes a single community.

It is to the last mentioned conception to which one must appeal when he pleads the case for a great redistribution of revenues conducted by the federal government which draws funds from the high-income provinces and distributes them to the low-income provinces. It has been urged that the residents of the various provinces are entitled to the same level of government services, at the cost of a common severity of tax effort, because services are provided at a uniform level throughout a country with a unitary government. This is what the residents of the poorly-endowed regions receive in return for giving up control over their economic destiny. These regions are often disadvantaged by the central government's tariff and monetary policies and are entitled to a quid pro quo, it is argued. We think that a stronger argument in equity - which does not deal in quid pro quos - is that all members of a family expect to be treated alike and the community is analogous to a family.

If this line of reasoning is accepted, one aspect of the evolution of the unity of the Canadian nation can be traced out in terms of the development of the equalising grants which were initially

part of the package deal wrapped up in the tax agreement contracts. When the 1947 tax agreements were signed, it was not clear that there was complete acceptance throughout the country that it lay within the constitutional competence of the federal government to levy general taxes to secure revenues to redistribute among the provinces to equalise somewhat the uneven fiscal capacities. It must be set down as one of the major accomplishments of the tax agreements that this function of the federal government came to be accepted. It only remains for the principle of 'fiscal equity' to be fully developed.

It would be going too far to say that there is now complete acceptance of the fiscal equity principle or that its implications are fully understood. The principle states that the residents of each of the provinces are entitled to a 'standard level' of government services attainable at the cost of a 'standard tax effort'. The principle was first enunciated by a public authority in Canada by the (Rowell-Sirois) Royal Commission on Federal-Provincial Relations. They coupled it with what might be called a 'provincial fiscal autonomy' principle. This is the declaration that the government of each province should be free to determine and provide whatever level of services its residents desire and are willing to finance. The provinces were to be put in a position where, if the residents so wished, the standard level of services could be provided at the standard tax cost. But if the residents wanted a lower level of services, taxes could be commensurately lower. Conversely, if the residents of a province wanted services higher than the standard level, taxes should appropriately be commensurately higher. (Strictly speaking, the 'fiscal equity' principle is not precisely met unless

similarly situated persons in each province enjoy the same 'fiscal residuum' i.e. excess of government services over tax contributions).

The fiscal autonomy strand of the Rowell-Sirois thinking was not followed. If it had been, there would have been little or no resort by the federal government to conditional, matching grants. It may be that the federal and several provincial governments were more perceptive of the public sense of and desire for unity than were the members of the Rowell-Sirois Commission. Alternatively, it might be said that the unifying experience of the second world war transformed public sentiments away from a feeling of diversity to a sentiment of unity. It might be claimed that the most important defence of the federal 'encroachment' upon provincial functions in the form of health and welfare conditional grant programs and the grants to universities stems from the assertion that the sense of unity is heightened by the initiative of the federal government in leading the way and guiding the course followed in the ushering in of the welfare state which should obtain in all parts of the country and not in just some provinces. What other interpretation can be put upon the emphatic assertion by the Premier of Ontario in 1951 that social hospital insurance should be a national and not a provincial program?

There are two basic problems of measurement which must be resolved in the implementation of the fiscal equity principle. One is involved in the calculation of the standard level of services or 'fiscal need'. The other concerns the less difficult problem of agreeing upon a measure of uniform tax effort - this is the 'fiscal capacity' aspect. There has been little explicit examination of or concern with the problems inherent in measuring fiscal need although the potential

problems to be resolved are realised and although it may be said that the special grants to the Atlantic Provinces are in recognition of greater fiscal need as well as low fiscal capacity.

There has also been a shrinking back from the full elucidation of the implications of the fiscal capacity side of the fiscal equity principle. Presumably everyone who has thought about the matter realises that the direct taxes - personal and corporation income taxes and the succession duties - constitute only half or less of the revenue sources of the provincial governments and considerably less again of the combined provincial and municipal revenues. To equalise fiscal capacities, deficiency grants would need to be calculated as the difference between: the yield in the province with the greatest fiscal capacity, of the agreed standard set of tax rates plus non-tax revenue especially from natural resources; and, the yield of these sources in the province in question. That this is so was recognised to a minor extent when half the average gross revenue from natural resources (during the prior three years) was included in the calculation of the equalisation grants.

Rather than an increasing inclination to make a comprehensive calculation of fiscal capacity, attention has centred upon the degree of equalisation in the income tax fields alone. We have shuttled back and forth between the national average yield and the yield in the two provinces with the highest per capita yield - and it happens that these two provinces constitute almost half the economy of the country.

An average is a calculation which is much used. But we cannot fail to mention, in passing, that it has no significance as a standard. Whatever the national average yields per capita of a standard set of tax rates might be as a percentage of the per capita yield of these

rates in the province with the highest yield - 60, 70 or 80 per cent - is surely quite a haphazard matter determined by a multitude of factors. If that percentage happened to be, say, 70 per cent, when one said: "let's choose the national average as the level to which we raise the provinces with the lowest fiscal capacity", he would actually be choosing 70 per cent. We think it a virtue to know what percentage is being chosen. How else can one decide the question: to how much below the level of the highest are we raising the low fiscal capacity provinces? This is the same as answering the question: to what extent are we approximating a uniform level of fiscal capacity?

It can be argued that the preservation of national unity requires a progressive movement toward a uniform capacity to provide services at the cost of a standard weight of taxation. The really difficult problems lie in the identification of the services which should be included in the standard set of government services - i.e. the defining of fiscal need. Presumably these services would include all those which are not to be paid for on the basis of the 'benefit' or 'commercial' principles; that is, all services the costs of which are not made a charge upon the users on the basis of a pro rata allocation of cost according to the amount of the service consumed or some reasonable approximation of it.

Appendix to Chapter IThe Tax Rental and Tax Collection Agreements1867 - 1941

It is possible to view the history of the division of tax revenue sources between the federal government and the provinces as almost a century of struggle by the provinces to obtain revenues commensurate with their expenditure responsibilities. The period which marks the major exception to this sweeping generalisation is the decade of the 1920s.

The four provinces which entered Confederation in 1867 were given tax sources which in total produced less than half, one-fifth their revenues in 1866. Since fees, income from natural resources and other non-tax revenue were not sufficient to balance provincial budgets and since there was little expectation that the provincial power of direct taxation would be much used, the Dominion government reluctantly agreed to pay the provinces small, fixed, annual subsidies calculated to make it just possible for them to meet their commitments. The subsidies were stated to be in full and final settlement of all claims of the provinces on the Dominion. Uniformity was desired but New Brunswick had to be paid an extra, ten-year special grant, on the ground of special need.

These payments at once proved inadequate and revisions were made in 1869 and on each admittance of a new province. Despite these concessions by the federal government, the provinces were thrown on their own resources to find additional revenues. British Columbia levied income and land taxes in 1876, Prince Edward Island a land

tax from 1877 to 1882 and Quebec imposed taxes on corporations (per paid-up capital, place of business, etc.) in the 1880s. Ontario pioneered with succession duties in 1892 and was copied by all other provinces. In 1894 Prince Edward Island restored its land tax and imposed a personal income tax. But all these direct taxes produced only about 10 per cent of provincial revenues in 1896 compared to the 38 per cent represented by the statutory subsidies. For Manitoba, which had no revenue from natural resources, and for the Maritimes the statutory subsidies remained the principal source of provincial funds.

Finances were somewhat eased when the great depression ended in the mid-1890s. Federal tariff revenues rose rapidly and, following the 1906 federal-provincial conference, an amendment to the B.N.A. Act increased the statutory subsidies by about one-third. This revision, however, increased the subsidies as a percentage of total provincial revenues only temporarily. This percentage was 23 in 1905, 29 in 1906 and 22 per cent in 1911.

During the first world war the Dominion government first imposed personal and corporation income taxes - in 1917. Other changes during and immediately following the war included new excise taxes and a general sales tax. Thereafter, during most of the post-war period, the federal government was preoccupied with its burdens -- the war debt, war pensions and the deficit of the Canadian National Railways -- and followed a conservative financial policy. It undertook few new heavy expenditure obligations, its half-share of the cost of old age pensions (1927) being a major exception. Federal corporation and personal income tax rates were treatly reduced and the sales tax cut from 6 to 1 per cent.

In the same decade the great new tasks of government -- highways, electrical power lines and welfare services -- fell to the provinces. Significantly, in sharp contrast to the great increase in capital outlays and debt, current expenditures of the provinces remained about the same per capita as in 1914. But their composition changed: more being spent on education, mothers' allowances, child welfare, mental hospitals and direct relief for the unemployed; and, less for the traditional functions of justice, legislation, public domain, agriculture and transportation. To keep pace with their increased debt servicing costs, the provinces drew larger revenues from the sale of liquor through provincial government outlets, automobile licenses and gasoline taxes.

Rapid urbanization led to a large increase in municipal capital expenditures and debt.

Once again, the provinces were unequally affected by the economic expansion and a royal commission was appointed in 1926 to study the grievances of the Maritimes. When the commission's recommendation of an approximate doubling of these provinces' statutory subsidies was supported by the other provinces at a federal-provincial conference in the following year, the federal government acceded. The four western provinces then requested that their subsidies be raised on the ground that their financial resources were not adequate for their responsibilities. But the federal government turned a deaf ear to these and other requests, notably that it take over certain of the new services and withdraw from the income taxes. In 1930, however, the federal government bowed to the demand of the Prairie Provinces for the transfer of ownership of their Crown-owned natural resources to them and for compensation for their past use.

At the close of the twenties, the provinces and municipalities were spending in total almost half as much again as the federal government and the statutory subsidies amounted to between 8 and 9 per cent of total provincial revenues.

When the severe depression of the 1930s fell upon them, all governments engaged in a scramble for new taxes in a vain effort to balance budgets. The failure of these endeavours in the less wealthy provinces and the uneven incidence of the depression forced the federal government to make large inter-government transfers. The number of provinces levying personal income taxes increased from three to seven and all provinces taxed corporation profits. At the same time the federal tax rates were approximately doubled, its sales tax increased from one to 8 per cent and many new excise taxes imposed. Provincial gasoline taxes were raised by half, on average; retail sales taxes were introduced in Saskatchewan and Quebec and Montreal and Quebec City. Succession duty rates were raised and exemptions lowered. In addition, some taxpayers suffered double taxation owing to overlapping administration.

Direct federal assistance was extended to all provinces to help finance the costs of relief to the unemployed and the federal government was further obliged to extend aid to farmers and to urban unemployed, in the form of grants-in-aid. In the aggregate, a third of provincial revenues came from the federal government, largely in relief assistance; in some provinces the proportion was nearly twice that amount. Along with the relief grants, special assistance had to be given to the most hard-pressed provincial governments to prevent defaults in debts and to make possible the continuation of essential services. The breakdown of the finances of the Prairie Provinces made

them near-wards of the federal government. No wonder, therefore, that the federal government appointed the Royal Commission on Dominion-Provincial Relations -- the famous Rowell-Sirois Commission -- in 1937.

Many of the commission's recommendations have been partly implemented and the report still casts its shadow over all federal-provincial deliberations. The main recommendations were:

- a) that the responsibility for relief to unemployed employable persons be transferred to the federal government;
- b) that responsibility for most social welfare services be left, at least temporarily with the provinces, except contributory old age insurance if this should be adopted; the Commission opposed joint jurisdiction and criticized the shared-cost, conditional grant mechanism;
- c) that the income taxes and succession duties be used solely by the federal government; the objectives were to end undesirable forms of corporation taxation, improve efficiency in collection, reduce costs of compliance and end double taxation of the same income;
- d) that unconditional grants be paid by the federal government to equalize the fiscal capacities of the provinces, the grant to a province was to be equal to the excess of the expenditure necessary to provide the average Canadian standard of government services over the revenue which would be derived from taxation of average severity;
- e) that the federal government should pay an emergency grant for a year at a time to any province in special temporary

difficulties; and,

- f) that the federal government assume outstanding provincial debt.

On the Commission's calculations, Saskatchewan would receive a special emergency grant and all provinces but Ontario, Alberta and British Columbia would receive the equalizing grants.

It was November of 1940 when the Prime Minister summoned the provincial governments to attend a conference "to secure, if possible, the adoption of the Commission's recommendations." The conference met in January of 1941 and broke down on the second day. It served, nevertheless, to set the stage of the temporary co-ordination of government finances during the war period.

The Wartime Tax Agreements

There was really no alternative to provincial agreement to the proposals made in the Wartime Tax Agreement Act to clear the decks for federal direction of the nation's finances. All provinces and municipalities withdrew from the personal and corporation income taxes. The payments offered in compensation were tailored to win acceptance. There were two options:

- a) net interest paid on provincial debt less inheritance taxes collected by the province in its fiscal year ending nearest to 31 December, 1940;
- b) provincial plus municipal revenues from the renounced taxes, in the fiscal year ending nearest to 31 December, 1940.

The federal government also guaranteed the existing level of provincial revenue from gasoline and liquor (the latter guarantee

was costless to the federal government). In addition, after the usual horse-trading was completed, Saskatchewan, Manitoba and the Maritime Provinces retained a substantial part of their special subsidies by way of 'fiscal need' and 'loss of revenue' grants.

The Conference on Reconstruction, 1945

In 1945 the federal government enacted a series of acts designed to further social welfare in Canada and to enable it to discharge the responsibility for the maintenance of a high and stable level of income which it had accepted in the White Paper on Employment and Income in April of that year. The legislation provided for price supports for farm products and fisheries, made provision for the transition to a peacetime economy in many fields, and inaugurated family allowances. Meetings of health experts from both levels of government had also been held to work out a detailed scheme for provincial hospital insurance, which was to be substantially assisted by the federal government.

The federal package of proposals presented to the provinces at the conference may be said to represent, in several respects, the carrying forward and further development of the Rowell-Sirois proposals; in another light, the package appeared to be designed to enable the federal government to continue its wartime assumed role of running the country more or less as though Canada had a unitary government. The main proposals were:

1. Division of Tax Fields: the federal government alone to use taxes on personal income, inheritances and corporations. The rental payment was to be a flat per capita sum payable to each province. (It might be remarked that this type of rental would

result in the full equalization of fiscal capacity of the provinces with respect to these three taxes.)

2. Universal Old Age Pensions: the federal government would assume complete responsibility for pensions to persons 70 and older without means test; and, would repay the provinces for half the cost of pensions to persons aged 65 to 69 with a means test.

3. Health Insurance Grants: the federal government would make grants to the provinces in aid of public health and of hospital construction, assist the provinces to set up health insurance programmes and repay them for 60 per cent of their operating costs.

4. Federal Responsibility for Full Employment: the federal government would extend unemployment insurance to all employees in Canada; extend assistance benefits, as a standby measure, equal to 85 percent of the insurance benefits, to unemployed employable persons not yet or no longer eligible for insurance benefits; and extend assistance to encourage the anti-cyclical timing of public investment.

5. As compensation for the provincial loss of the use of the income taxes, the federal government would pay \$12 per head of the 1941 population as a minimum; actual annual payments were to be calculated by increasing the minima in proportion to the increase in Canada's per capita G.N.P. since 1941. These payments were to supplant all existing statutory and special subsidies and unconditional grants.

The conference sat in full session from August 6 to 10, 1945 (with the war's end only five days away) and then set up a co-ordinating committee which met in November, January and April. The conference met again in full session from April 29 to May 3, 1946 and

then adjourned sine die. During this period the provinces put questions to the federal government, made proposal and submitted briefs although the only province to submit a full set of counter-proposals was Ontario, which submitted two. No agreement was reached although the federal government pressed for the completion of new agreements in time to replace the Wartime Agreements without a break.

Accordingly, a new offer was made in the 1946 budget, the objective being to secure tax agreements with as many provinces as were willing to negotiate. In theory if not in fact, the terms also avoided financial pressure upon any province which elected to resume its own taxation in the three fields of personal and corporation income taxes and the succession duties. Negotiations followed and seven provinces, excluding Ontario and Quebec, agreed to rent the three tax fields. (It is salutary to keep reminding oneself that the two largest provinces comprise almost two-thirds of the economy).

The mechanics of the agreements were:

- a) No province imposed a tax on personal income. If a province had chosen to do so, it would have had to administer and collect the tax itself (a strong deterrent to provincial initiative at that time but the taxpayer would have been granted a tax credit against the federal income tax payable, of up to 5 per cent of his federal tax liability. In 1950 Ontario enacted a tax equal to 5 per cent of the federal tax but did not proclaim it; for a time it sought, without success, to have the federal government collect the tax.
- b) The provincial share of the corporation profits tax was set at 5 per cent of taxable profits. All provinces which

sighed agreements imposed uniform taxes of this weight which were administered by the federal government in conjunction with its own. On the expiry of the Wartime Tax Agreements, Ontario and Quebec imposed taxes of 7 per cent on corporate income and other taxes on corporations on miscellaneous bases (place of business, etc.) estimated to be the equivalent of $1\frac{1}{2}$ per cent of profits. The formulae used by these two provinces and the federal government for the determination of the province within which corporation profits were deemed for tax purposes to be earned, were not uniform. This non-uniformity had the effect that corporations within the same industry and doing business throughout Canada bore different weights of tax. For example, an Ontario company might find that only 90 per cent of its profits were taxed by Ontario, Quebec and the seven provinces which signed tax agreements; another Ontario company might find that 110 per cent of its profits were so taxed. Agreement to use a uniform basis for allocating profits to the different provinces was not achieved for about another 10 years.

- c) Only Ontario and Quebec imposed inheritance taxes, which they administered themselves (as they did their corporation profits taxes). Credit was given for these against the federal tax up to a maximum of one-half the federal taxes. The result was that, ever since, the level of succession duties (and later estate taxes) has been roughly the same across Canada. Quebec and Ontario also agreed upon measures to prevent the double taxation of the same inheritance

(i.e. more than 100 per cent of the inheritance being subject to tax by a combination of the taxes of the two provinces).

- d) The provinces which agreed to rent their three tax fields received payments constructed and amended to win their agreement:

Option 1: \$12.75 per capita of the 1942 population plus one-half the revenue of the province from personal income and corporation taxes in 1940 (as determined for purposes of the Wartime Agreements plus the statutory subsidies payable to the province for the year 1947.

Second Option: \$15 per capita of the 1942 population plus the statutory subsidies payable to the province for the year 1947 (more favourable than Option 1 to Nova Scotia and Saskatchewan);

Third Option: a flat amount of \$2,100,000 (included for P.E.I.). These were the 'guaranteed minimum payments'; the actual payments for a year was increased in proportion to the increase in the population of the province and Canada's gross national product per capita, for the average of the three years previous as compared with the 1942 base year.

- e) The federal government also withdrew from certain tax fields, making room for the provinces: e.g. taxes on gasoline, the sales tax on electricity and gas used in residences, and taxes on amusements, cabarets and pari mutuel betting. All these arrangements did not free the provinces from the need to find more revenues. British Columbia, New Brunswick and Newfoundland (after its entry into the union in 1949)

imposed retail sales taxes.

- f) On its own initiative the federal government began implementation of the expenditure programmes proposed to the Conference on Reconstruction. It extended conditional grants in aid of public health and hospital construction. Saskatchewan and British Columbia went ahead with public hospitalization insurance on their own; the national programme was deferred until 1958, and the universal old age pension without means test until 1952. The federal unemployment insurance programme has been successively extended. But the proposals for the anti-cyclical timing of public works projects fell by the wayside. Partly in fulfillment of its commitment to several of the provincial governments to confer with them at least a year before the expiry of the 1947 agreements (at the end of March, 1952), the federal government called a federal-provincial conference in 1950, to discuss general questions of common concern. The Korean war crisis, however, caused the agenda to be a restricted one. The main accomplishment of the conference was in laying the foundation for the introduction of the federal old age pension and for its grants in aid of old age assistance, with means test, to persons aged 65 to 69. Proposals for new tax agreements to take effect on the expiration of the 1947 ones, were also laid before the conference.

The 1952 Agreements

The distinguishing characteristic of the 1952 agreements was that Ontario, following a long hesitation after the 1950 conference, decided to join the club temporarily. Her entry was smoothed by the addition of another option to the bases on which the rental payments were calculated. The option was, in effect, the yield of the 'provincial share' of the rented tax fields, namely the sum of:

- a) the yield of a personal income tax of 5 per cent of the 1948 federal rates applied to 1948 incomes in the province;
- b) the yield of an $8\frac{1}{2}$ per cent tax on corporation profits earned in the province in 1948;
- c) the average revenue from succession duties in the fiscal years 1947 to 1949; and,
- d) statutory subsidies payable to the province for the year 1948.

This was the method of calculating the 'guaranteed minimum' payments (the stabilization element). The actual payment for a year was the guaranteed minimum increased in proportion to the increase in the population of the province and of Canada's gross product at factor cost (a change from the G.N.P. at market prices which was used for the 1947 agreements) between 1948 and the year prior to the year in respect to which the payment was made (the 1947 agreements used the three prior years; the change increased the rental payments). The minimum payments under the other options were adjusted from the 1940 base year to a 1948 base; this increased the guaranteed floor payments by about one-half but did not affect the actual payments.

While renting both her income tax fields, Ontario continued to collect her own succession duties; to compensate, the rental payments to here, calculated as just described, were reduced by an amount equal to the tax credits allowed by the federal government for duties paid to Ontario.

Another technical change was that the 5 per cent tax on corporation profits with each province which signed a rental agreement was required to levy, for collection by the federal government, was dropped. The federal government raised its own tax rate correspondingly and granted a tax credit of 5 per cent of profits earned in a province which did not sign an agreement (i.e. Quebec).

In short, the 1952 agreements were substantially a continuation of the 1947 arrangements. No greater provision for revenue to be drawn from the income taxes was made for the province which chose not to sign an agreement. As before, the financial pressure on any province which insisted upon remaining outside the club consisted of two main elements: a) that province would have to collect its own personal income tax, requiring its residents to complete two tax forms; and b) the province would forego the difference between the tax rental payments offered to it and the yield of the income taxes and succession duties which it collected. Since Quebec did not impose its own tax on personal incomes until 1954, the financial penalty it suffered had grown, by 1952, to substantial proportions. In 1953 the federal government increased its tax credit for corporation profit taxes paid to provinces, from 5 to 7 per cent of taxable income; this improved the position of corporations paying the provincial tax but put no more funds into the Quebec treasury.

Otherwise, matters remained much the same. Some of the provinces which signed agreements were apparently quite happy with the arrangements although the Maritimes continued to press for a greater recognition of their deficiency in fiscal capacity. Some provinces which signed agreements still objected in principle, with greater or less conviction (Ontario, Alberta and Nova Scotia). Some provinces, particularly British Columbia, continued to protest that the federal government left too little room for the provinces to raise revenue. The defence of the arrangements became more attenuated each year. And most important, with Ontario's capitulation Quebec became more isolated than ever. It seems in retrospect that the failure of the federal government to make Quebec's financial position viable was a major lapse in the statesmanship of federalism.

In 1954, the Premier of Quebec crossed his Rubicon and imposed a tax on personal incomes originating in the province at rates approximately equal to 15 per cent of the federal tax. The task of administration and collection was lightened and political resistance avoided by setting the basic personal exemption at \$1,500. (A married man with no children would therefore pay no provincial tax if his income was less than \$3,000). The Prime Minister of Canada responded to this manoeuvre by privately meeting with the Premier of Quebec. The latter subsequently withdrew some objectionable parts of the preamble to the provincial act; in return the federal tax credit was increased to 10 per cent of the federal tax. Since the province's personal exemptions were higher, this had the result that only residents of Quebec with high incomes bore a significantly heavier personal income tax than did persons resident

elsewhere in the country. For the years 1958 to 1961, the tax credit was increased to 13 per cent.

The 1957 Agreements

The federal offer for renewal of the agreements, made public after two conferences had been held with the provinces, was contained in a letter from the Prime Minister to the provincial premiers in January of 1956. This offer went most of the distance toward removal of the financial penalty suffered by any province which preferred not to enter tax agreements. As expressed by one observer at the time: in keeping with the illusive new doctrine of 'minimum provincial entanglements' which required that the federal government confront the premiers with a monolithic indifference to their decisions, neutrality became the order of the day. Neutrality was evidenced by the offer to collect provincial taxes on their behalf -- something the federal government had steadfastly declined to do previously; making the tax field rental, in effect, the yield of the 'standard provincial rates' of tax; and, splitting off the equalization of fiscal capacity elements of the rental payments and making them payable whether a province signed agreements or did not. Because of this new neutrality -- the removal of financial pressure upon any province to accede to federal control and domination of the income taxes -- 1957 may be taken to mark the end of the tax agreement approach and the beginning of the tax collection era. At any rate, this is our interpretation even though no province accepted the 1957 offer of the federal government to collect taxes on its behalf.

Under the 1957 agreements, payments took three forms:

a) Tax rental payments: if a province agreed not to levy any or all of the personal or corporation income taxes or succession duties, it received:

- i) 10 per cent of the federal personal income tax collections attributable to the province (raised to 13% in 1958);
- ii) 9 per cent of corporation taxable income (hence about one-fifth of the yield allocated to the province by federal rules of such allocation; and,
- iii) 50 per cent of the federal succession duties (later estates tax) allocated to the province under federal rules.

These amounts were known as the 'standard provincial taxes'. The rates also served as the abatements or credits which the federal government allowed taxpayers to deduct from federal tax payable on income or successions allocated to a province which did not sign a tax agreement with respect to the tax in question.

b) Equalization payments: all provinces received unconditional grants equal to the difference between their per capita yield from the three taxes at the standard rates and the weighted average per capita yield in the two provinces with the highest per capita yields (Ontario and British Columbia) times their population. (Hence almost complete equalization of fiscal capacity was applied to the standard rates of the three tax fields, i.e. a return to the proposal of the Conference on Reconstruction but a half-way house on the road to the Rowell-Sirois recommendation). In 1958 the payment of the Special Atlantic Provinces Adjustment Grants of \$25 million annually began. In addition, the Newfoundland Additional Grants Act provided for \$8 million annual 'transition grants' to that province.

c) Stabilization Payments: all provinces which signed tax agreements were guaranteed that their total payments would not fall below 95 per cent of the average payments for the previous two years or below what they would have received had the previous arrangements been continued. The latter was the usual necessary political concession. The former continued the increasingly uneasy allegiance to the anti-depression concern of the Conference on Reconstruction.

Ontario rented only its personal income tax field; Quebec maintained her record of not signing; all other provinces continued to rent all three fields.

With the conclusion of these agreements, 'rational taxation' may be said to have been achieved to a considerable degree in three ways. Inequitable double taxation had been eliminated. The fiscal capacities of the provinces were evened up in one large segment of provincial revenues. Provision was made to prevent a sharp drop in the same large segment of provincial revenues should a depression occur (it was open to the federal government, in an emergency, to extend the benefit of the stabilisation provision to apply to provinces which did not sign agreements).

A bit more room was also made for provincial revenues when the federal government ended its 2 per cent tax on insurance premiums as of January 1, 1957.

What grievances, then, were left for the provinces to pursue? First, it could still be argued persuasively that the provinces lacked revenue sources commensurate with their expenditure responsibilities. But this is not an open and shut issue. It is doubtless the most difficult and contentious of the problems referred to the Tax Structure Committee appointed by the Federal-Provincial

Conference in October, 1964 and which is in the midst of its deliberations. In the body of this chapter it is argued that the division of revenue sources implicitly presupposes an acceptance of some division of functions between the two levels of government and the relative priority of additional expenditure programmes to be taken on and expenditures to be made. Since expenditure aspirations continue to outstrip the increase in the yields of existing rates of tax, any agreement concerning the division of revenue sources also implicitly carries with it implications concerning which tax rates should be raised and what new taxes should be levied.

The second complaint to which the 1957 arrangements were open was, of course, the incomplete admission of the inequality of fiscal capacities of the various provinces. Regard was paid only to the revenues drawn from the three rented tax fields; some distance had yet to be travelled before the problem was confronted as forthrightly and comprehensively as it was by the Rowell-Sirois Commission.

Third, the floor placed under provincial revenues by the stabilization payments was perhaps adequate for mild recessions and therefore a welcome continuation of the concern shown by the Conference on Reconstruction for the prevention of severe depressions. However, it is fair to say that the 1957 arrangements, at best, only provided a basis upon which fiscal measures to cope with periods of inadequate economic expansion -- such as 1958 to 1961. A programme for attacking this problem, which is potentially very much with us still, was not articulated.

In short, the three areas in which the 1957 arrangements marked a greater degree of achievement than ever before in the history

of our Confederation, were also the three areas in which more remained to be accomplished.

The 1962 Tax Collection Agreements

In the years following 1957 the federal government continued to be concerned to disengage itself from entanglements with the provincial governments concerning the sharing of tax fields and other financial relations. It was possible for the casual observer to form the impression that the federal cabinet gave undue weight to the representations made at the recurring federal-provincial conferences by some provincial premiers.⁽¹⁾ While it is true that

(1) As the Minister of Finance said (House of Commons Debates, vol. vii, July 11, 1961; 1960-61 Session, p. 7911):

"Under such circumstances it became increasingly evident that the tax rental system was unsound. It placed on the federal government the whole responsibility for levying the additional taxes to support large increases in provincial expenditures. The provincial governments assumed no responsibility for imposing the rented taxes on which they depended for revenues nor had they any freedom to amend the rates of these taxes in line with their current needs. Such a system was clearly destructive of provincial responsibility and initiative and incompatible with the constitution which grants equal access to the federal and provincial governments in these fields of direct taxation."

there was usually one or two premiers who used these meetings to demand the moon on a platter, it is quite uncertain how seriously they expected to be taken. The Premier of British Columbia, for example, has for a decade made demands for a larger share of federally collected revenues which were among the most extreme but he also pressed for a federal government financial participation in provincial expenditure programmes which were equally extreme.

The new government in Ottawa also brought with it a somewhat different approach to federal-provincial arrangements. It introduced a plethora of new conditional grant, shared-cost programmes which entangled it deeply with the provinces. But, simultaneously, it sought to throw the provinces more completely upon their own resources and to induce them to accept the initiative for increasing their revenues and to bear the political odium of raising tax rates. The abandonment of the tax rental agreements and of the Rowell-Sirois concern that the level of the income taxes be the same in all provinces, was required for the federal government to achieve these objectives.

The federal government announced that the rental agreements would be replaced by arrangements which were exclusively tax collection arrangements.

During the terms of the present arrangements the federal government grants and 'abatement' of 16 to 24 per cent of the gross federal personal income tax payable. (Originally set at 16 per cent for the 1962 taxation year, rising by one per cent each year to 20 per cent for the 1966 taxation year; by subsequent amendments the abatements were increased to 21 per cent for 1965 and 24 per cent for 1966.) That is, the taxpayer calculates his federal tax liability

and then reduces it by e.g. 21 per cent for the 1965 taxation year. He then adds his tax liability, for all provincial taxes except that of Quebec, which still administers its own personal income tax. The provincial taxes imposed by all provinces except Manitoba, Saskatchewan and Quebec are the same amount as the federal tax abatement. The Manitoba and Saskatchewan taxes are 6 percentage points higher than the federal abatement. That is, for 1965 their tax is 25 per cent of the gross federal tax (as calculated before the tax abatement is deducted). For 1966 the tax of these two provinces will be 26 per cent of the gross federal tax. The amounts shown as the provincial tax liability are remitted to the federal government, along with the federal tax, for transfer to the provincial governments. The Quebec taxes are about the same as the federal abatements and the personal exemptions are the same as those of the federal tax. There is therefore only a moderate degree of variation in the levels of personal income taxes among the provinces.

The federal collection of the provincial taxes still retains, of course, a considerable attraction for the taxpayer -- it simplifies his compliance considerably -- and for nine of the provincial governments. To gain the benefit of federal collection, a provincial government must accept two constraints upon its freedom of action. First, the calculation of income subject to tax must be the same for provincial taxes as it is for the federal tax. Second, the provincial tax must be stated as a percentage of the federal tax liability. Accordingly, if a provincial government preferred a different tax progression (the increase in the ration tax liability divided by taxable income as taxable income increases) it must forego its preference. Also, if a provincial government considers that the

federal definition of taxable income is faulty, it must live with it. For example, a provincial government may prefer that the amount of income free of tax because it falls within the definition of capital gains, is excessive. If so, it must live with the federal definition nevertheless.

The federal abatement of its corporation income tax is 10 per cent of taxable profits earned in Quebec and 9 per cent of taxable profits earned in all other provinces. The rules used by the federal government and the provinces to determine the province within which corporation profits are deemed to originate, are now uniform. The one per cent extra abatement of federal tax on profits earned in Quebec is a carrying forward of the agreement reached in 1960 that a province should receive a compensating share of the income taxes if it preferred that its universities not receive the federal grant of \$2.00 per head of the province's population (originally \$1.50). This may be said to be the first 'opting-out' provision.

As with the personal income tax, the provinces are free to impose whatever rates of corporation income tax they choose. Ontario and Quebec choose to collect their own taxes -- at rates of 11 and 12 per cent respectively. Manitoba and Saskatchewan choose to impose corporation taxes of 10 per cent -- 1 per cent higher than the federal abatement. The other provinces levy taxes equal to the federal abatement. Taking the tax abatement into account, the result is that the combined federal and provincial rates are higher than in the other provinces, by two per cent of profits in Ontario and Quebec and 1 per cent higher in Manitoba and Saskatchewan.

Since the provinces cannot constitutionally levy an estate tax, which is the form of death duties now used by the federal government, because it is considered to be an indirect tax the federal government continues to rent this field and return 50 per cent of the collections to the provinces which wish to sign rentals agreements. Seven provinces are presently parties to these rental agreements. British Columbia, Ontario and Quebec impose and collect their own succession duties; a tax credit of up to 50 per cent of the federal estate tax may be claimed as a deduction from federal tax liability.

The shift from tax rental to tax collection agreements therefore had two main consequences. The rates of taxes now vary among the provinces formerly part to the tax rental agreements. Second, the new freedom to vary rates has probably increased the likelihood that reductions of federal rates would be absorbed by provincial rate increases. This has not yet happened with respect to the decreases in the rates of the federal personal income taxes announced in the 1965 budget, however.

The changes consequent to the decision to switch from rental to collection agreements were minimised by the 1957 institution of the payment of equalization grants as a separate matter, unaffected by the other elements of the federal-provincial financial arrangements. Under the 1962 arrangements, the equalization payments were continued but the formula changed. First, the level to which fiscal capacities in the direct tax fields was to be raised, was the national average per capita yield. Second, natural resource revenues were recognised as an important source of fiscal capacity (but in a peculiar way since gross revenues are used and these are much higher than net revenues which are sometimes negative for the Crown forests. The equalization

payments were set at: the national average per capita yield of the federal tax abatements) for 1965, 21 per cent of the gross yield of the federal personal income tax, 9 per cent of taxable corporation profits and 50 per cent of the yield of the federal estates tax) plus 50 per cent of a three-year moving average of gross natural resource revenues minus the per capita yield of these revenue sources in the province, times the provincial population.

The new basis for calculation of the equalization payments disqualified some provinces from receipt of them hence some provinces would receive less under the new arrangements than under the old. Following the precedents that this must never occur, two guarantees were thrown into the pot. First, any province receiving an equalization payment according to the new formula was guaranteed that it would receive an equalization payment sufficient to bring its total receipts from the standard taxes plus equalization payment plus Atlantic Provinces Adjustment Grants up to what it would have received had the 1957-62 arrangements been continued. (Saskatchewan, Manitoba and Quebec benefited).

The second guarantee stated that no province would receive less than it did in the last year of the 1957-62 arrangements or the average of the last two, whichever was the greater. Alberta benefited.

The stabilization features of the previous arrangements were continued.

The Atlantic Provinces Adjustment Grants were increased from \$25 to \$35 million. All provinces except Alberta, British Columbia and Ontario were eligible for equalization payments.

Developments Since 1962

In the summer of 1960 a new government was elected in the Province of Quebec and the 'quiet revolution' began, accompanied by more effective demands by that province for financial arrangements which would enable it to realise its ambitious economic and social objectives. As early as 1961 the present Prime Minister of Canada suggested that an opting-out arrangement might make it possible for a province to follow a path divergent from that of other provinces, if it so desired. A new federal government was elected in April of 1963 and its budget proposals of the same year concerning the Municipal Loan Fund and the Canada Pension Plan encountered more united provincial government opposition than had greeted federal proposals at any time since the Conference on Reconstruction. The era of co-operative federalism began.

As mentioned, the provincial share of the personal income tax was raised from the 19 per cent of the gross yeild of the federal tax rates for 1965 and 20 per cent for 1966, to 21 per cent for 1965 and 24 per cent for 1966. In 1963, the equalization formula, beginning in the 1964-65 fiscal year, was changed back to the weighted average yield of the standard tax rates of income taxes and succession duties of the two provinces with the greatest yield per capita. But there was still to be a deduction for any province having natural resource revenue above the national average. The deduction is 50 per cent of the amount by which the three-year average of gross natural resource revenue exceeds the national average per capita, times the population of the province.

For 1964, the federal credit for succession duties paid to a province was increased to 75 per cent of the federal estates tax. In the same year, the federal government announced that the special annual grant of \$8 million to Newfoundland would be continued indefinitely.

Early in 1965, federal legislation was enacted enabling contracting-out agreements with a province, to be effective January 1, 1965 or January 1, 1966. The operation of these agreements and their implications are discussed elsewhere in this study.

When the Quebec government joined some of the other governments e.g. British Columbia, in demanding a larger share of the income taxes for provincial use, its demands may have sounded excessive. In fact, the proposals of the 1963-64 Quebec budget speech for example were quite moderate. These were a repetition of the proposals made at the July 1960 Federal-Provincial Conference and repeated to the November, 1963 Conference. Premier Lesage requested that the federal government withdraw completely from the succession duty field and partially from the personal and corporation income tax fields by a lowering of the federal tax rates to 75 per cent of their 1961-62 levels. This would mean that the provinces could collect taxes equal in amount to 25 per cent of the gross yield of the federal rates. For 1966 the federal abatements and credits are: 24 per cent of the yield of the personal income tax; 9 per cent of corporation income or about 22 per cent of the yield of the 1961 federal rates; and 75 per cent of the federal estate tax payable. Accordingly, the 1966 provincial share of the three taxes, before account is taken of the contraction-out agreements, is not greatly less than that proposed by the Government of Quebec.

Chapter 2

SOME PROBLEMS OF ECONOMIC CO-ORDINATION IN A FEDERAL COUNTRY

It is always possible that two governments may work at cross purposes by pursuing incompatible objectives. Certainly co-ordination of some sort is required to avoid such conflict. But how is such co-ordination most effectively achieved: by consultation, or by the unanimous acceptance of a set of ground rules - or is the complete withdrawal of one level of government from some spheres of activity required? Surely this can be judged only in the concrete; not in the abstract.

Another study prepared for the Commission¹, lists a number of areas of potential conflict as matters which, failing other solutions, require resolution by consultation. Since this list appears to be exhaustive, it is convenient to enumerate them here and discuss the several techniques of co-ordination with respect to them.

1. Provincial policies may inhibit the federal government's interest in maintaining the mobility of capital and labour within the national boundaries.
2. The objectives of some of the provinces are likely to lie in the direction of more differentiated and autonomous provincial economies than are compatible with national economic objectives.
3. Individual provinces may press for a closer economic integration with contiguous areas of other countries than is compatible with national policy.

1. By Professor Donald V. Smiley

4. Some provincial governments may adopt objectives concerning the patterns of foreign investment and trade which are incompatible with federal objectives.
5. The pursuit by some provinces of economic growth may bring them into conflict with federal policies at a particular time or may be detrimental to the growth of other provinces.
6. There may be disputes concerning general fiscal and monetary policies to aid growth and attain stability. At times some provinces protest that the central bank's tight monetary policy and federal fiscal restraints impede their economic growth and cause unemployment within their borders. The ground for such protest may be that the interests of one region are being sacrificed for those of another. Alternatively the dispute may turn upon different priorities accorded to employment and growth as opposed to the containment of inflation. The third way in which conflict may arise stems from the federal government's preoccupation with the effects of capital expenditures upon income and employment which contrasts with the provincial governments' concern with the need for services (highways, schools, etc.) and for the financial soundness of their municipalities.
7. Some provinces may protest that certain federal programmes which are of great benefit to other provinces do not benefit them and may even be to their disadvantage.
8. Finally, and perhaps most serious, disputes between the federal government and one or more provinces may simply reflect the endeavour of each to expand the scope of its operations. To continue in office, political parties must implement programs

which command broad support among the electorate. There may also be sincere differences in views concerning which level of government should perform particular functions. A special case of such conflict concerns the desire of a provincial government to have control over functions which assist it to realise particular aspirations.

As a second preliminary, the various techniques of co-ordination may be listed:

1. There may be a rigorous definition of the spheres of jurisdiction - with each level of government jealously guarding its prerogatives. This may not be co-ordination; but it is a division of labour. Unfortunately, this technique cannot provide a resolution of all conflicts because a single program may fall partly within the competence of a province and partly within that of the federal government. The Columbia River power development is an instance.
2. Conflicts may be avoided by the unanimous acceptance of a set of ground rules prescribing the agreed behaviour concerning certain functions, such as the acceleration of the economic development of regions of slow growth.
3. Potential conflicts may be avoided and potential disputes resolved in advance by consultation between governments or the two levels of government. Similarly, where there is agreement concerning the objectives such as the avoidance of inflation, and also a broad measure of agreement concerning the measures appropriate for attaining the objective, co-ordination can be effected by consultation.

However, 'consultation' has many shades of meaning.

- (a) It may simply mean no more than the right of the provinces to be informed beforehand of the federal government's intention to adopt economic programs or measures, and vice versa. This meaning carries the minimum commitment, consisting of nothing more than advance warning so that other governments may take into account the effect of the projected program upon their own activities.
- (b) Consultation may mean the discussion of impending measures or programs with other governments, leading to the revision and adaptation of the measures in the light of the reaction and comment of affected governments; and perhaps the co-operation of other governments by the adoption of supplementary measures and appropriate adaptation of their own programs. This variant involves the second to the least surrender of the right of independent action. Each party merely agrees to be amenable to persuasion. For example, the federal government might annually inform the provinces of its assessment of economic conditions for the year ahead and whether its fiscal measures will, on balance, be restrictive or expansive. It might agree to weigh all the considerations raised by the provincial governments and might even undertake to explain why it did not accept any argument or proposal of a provincial government. But it would not agree that the programs under discussion should be decided by the conference, that is, by consultation.

Like meaning (a), this meaning of consultation implicitly presupposes that there is no basic conflict of interests or, where they exist, some principle is accepted concerning the weighting of competing interests; and further that there is no basic disagreement concerning the measures or techniques most likely to achieve the objectives.

(c) Consultation may mean that, immediately the broad outlines of a projected program or set of measures e.g. tariff negotiations, are formulated by the federal government, they would be 'cleared' by consultation with the provincial governments and the latter would participate in the detailed development of the program or measures. But, still, the federal government would not undertake to abandon the program or surrender the function to the provinces if majority support could not be won.

(d) Consultation may mean co-jurisdiction. This entails full recognition by both levels of government that each should participate in the formulation of policy. To be harmonious, conventions whether majority decisions were binding, what constitutes a majority and powers of veto and non-participation would be needed.

4. There can be co-ordination and disputes resolved by plenipotentiary negotiation at arm's length, in the manner of sovereign powers entering treaties.

To summarise:

1. There can be a division of labor by each government going its own way in its own sphere.

2. There might be a set of rules prescribing permissible behaviour.
3. There might be consultation meaning:
 - (a) Each government gives advance warning of its acts, and no more.
 - (b) Each government gives notice of pending programs and is amenable to persuasion to modify them.
 - (c) Policies may be proposed and the detailed measures to implement them jointly formulated.
 - (d) Major policies may themselves be jointly formulated.
4. Formal agreements may be negotiated in the manner of treaties with foreign powers.

The mere listing of these techniques of co-ordination indicates that the relative effectiveness of one or other form depends upon the measure of basic agreement existing and the presence or absence of inherent conflicts of interest.

Accordingly, rather than leave the matters of potential conflict as general as the eight headings listed above (pp.48-50), it will perhaps add clarity to the discussion if specific examples of disagreements or conflicts are hypothesized. The various techniques of co-ordination can then be discussed with reference to each in turn. We start with matters in which there is likely to be least inherent conflict.

1. Fiscal Policy:

There has been considerable concern in recent years that the capacity of the federal government to be the balance-wheel of the economy might be undermined by the decrease in the magnitude of federal expenditures in relation to those of the provinces and municipalities and the diminution of the federal government's control over the rates of the income taxes. But how serious is this erosion of federal fiscal

power and how great is the need for the provincial governments to undertake counter-cyclical budgeting harmonious with the federal programs? To discuss this we must distinguish between two kinds of problems. First, there is the short period fluctuations of expansion and recession of about 20 months to four years duration. The dangers are twofold. At the peak of the expansion phase aggregate demand may become excessive so that demand exceeds supply for many types of labor and perhaps also some plant capacity, in most parts of the country and may cause inflation. During the recession phase the decline in aggregate demand may cause unemployment to be undesirably high in most parts of the country. The prescribed remedy is that governments run surpluses at the peak and deficits at the trough - which can be automatically accomplished to greater or less degree by the built-in stabilizers. The main problem in coping with these short oscillations is one of timing and the lapse of time between the budget remedy and its effects. These difficulties are sufficiently great that it seems unlikely that complete success will ever be achieved in the endeavours to iron out the oscillations. However, if the rate of increase of aggregate demand over the series of short oscillations keeps in step with the rate of increase in the labor force and in plant capacity, the consequences of the short oscillations may not be very distressing. Unemployment may rise for brief periods above the desired level and there may periodically be some moderate, though irreversible, rises in the price level (though the latter may be attributable to causes other than excess aggregate demand).

It seems therefore that provided the provinces and municipalities follow a stable program of expenditures, whatever measures can be successfully undertaken to cope with the short duration oscillations lie within the capability of the federal government despite its reduced fiscal power as compared to a decade ago.

The undesirable economic consequences are greater when the rate of expansion in aggregate demand over several years, covering more than one short oscillation, falls short of (or exceeds) the rate of increase in the labor force or if, during a period of similar length, the increase in aggregate demand is insufficient to reduce an undesirably high rate of unemployment initially existing. When this happens the problem is beyond correction by the built-in stabilisers (which may even act perversely) and stronger measures are required. However, provided that forecasts concerning the duration of the imbalance can be made with sufficient confidence, the problem posed by the lapse of time between budget action and its effects, is not insuperable. But the magnitude of the measures to be taken may be very large. Are they likely to be beyond the present fiscal powers of the federal government, again assuming that the provinces and municipalities adhere to orderly, steadily expanding programs of expenditures, a stable proportion of which is financed by borrowing? This matter would warrant a study in itself and dogmatic assertions would be foolish - who can foresee how great an imbalance is likely to occur in the future? However, some light can be thrown on the problem by considering the precise measures which the federal government is likely to undertake.

Firstly, we can put transfer payments and other welfare programs to one side. Surely there is not likely to be any retrenchment and it is inappropriate that major extensions be undertaken to bolster aggregate demand in a particular period, rather than letting the extensions be determined by their merits. (Although it might be appropriate to advance the date of the coming into operation of an imminent program). Accordingly, it does not greatly matter for fiscal policy whether the welfare programs are federal or provincial functions.

The federal government has always been in great difficulty in its endeavours to vary expenditures on goods and services since the provinces and municipalities are the big spenders on these functions. In the event that a severe, prolonged recession is forecast, it surely must convene a conference and plan a concerted program with the provinces pushing money over to them to increase their spending. It is difficult to see how the events of the past decade have changed matters greatly in this respect.

Much reliance must also be placed upon varying revenues and the tax best suited to this purpose is the personal income tax. Here the necessity for provincial co-operation arises not so much from the hope that they would adopt measures similar to those of the federal government but rather to ensure that they did not engage in perverse action, by raising their rates when the federal government lowered its own. How likely such behaviour might be is a matter for speculation but consultation, in any of its meanings, would doubtless minimise the probability of the event. It is difficult for one to imagine acute conflicts of interest which would pose severe problems of inter-government co-ordination when the problem calls for increasing aggregate demand.

When the problem is inflation due to excessive aggregate demand existing for more than a brief period at the peak of a short cycle, conflicts of interest are more likely. If the federal government decided that the most desirable remedy is that provincial and municipal spending be curtailed, inter alia, there might well be room for argument concerning the wisdom of its decision. In any event, since most of the provinces possess the power for an independence of action, the appropriate form of co-ordination of actions would appear to involve the recognition of co-jurisdiction. Obviously, consultation of this sort takes time and robs fiscal policy of some of the flexibility which it might otherwise have. But the difficulty is inherent in the federal form of government.

In addition, even when the general problem is inflation, some provinces may be suffering from undesirably high unemployment, and would justifiably protest against any measures which would reduce employment within their borders. In these circumstances, however, it is difficult to imagine why the federal government would request a curtailment of provincial and municipal expenditures in the distressed areas or even to curtail the expenditures of its own agencies there. Moreover, an effective attack upon chronic, regional unemployment must be by measures other than the balance-wheel operations of the federal government and it would seem unnecessary for these measures to be interrupted or impeded by considerations of counter-cyclical budgeting.

If this analysis is correct, no fundamental conflict of interest is apparent, which need lead to disputes which could not be reconciled by a moderate measure of consultation.

It also appears from the analysis that, except during prolonged periods of imbalance, there is no functional reason why fiscal policy should not remain primarily a federal responsibility. That is, one is at a loss to know what would be gained if it should be successfully maintained that overall fiscal policy should fall into the arena of co-jurisdiction. It has been reasoned that the federal government, to be realistic, must recognise co-jurisdiction whenever it wants provincial governments to supplement its own programs by increasing or curtailing their capital expenditures. This is because the provinces possess the power of independence of action. But it has been reasoned that the appropriateness of such provincial initiative is restricted to periods of prolonged imbalance; such initiative is not needed (and indeed may be disequilibrating) in 'normal' circumstances. Of course it can be argued that, in the periods of prolonged imbalance, the federal government could achieve its ends by persuasion, without recognising co-jurisdiction. But it can also be argued that the presentation of a program as a fait accompli with an invitation to the provincial governments to rally round the flag, is not the most astute procedure. At a minimum, consultation meaning joint formulation of the details of a program seems the course of wisdom. Surely such a procedure would minimise the chances that the main objective would be lost sight of by the mergence of a rivalry between governments concerning which should have the initiative - which should be the first among equals. The concern that joint programs may be made ineffective by irrelevant rivalries may be put down as a major reason for wanting fiscal policy 'in normal circumstances' to remain primarily a federal function.

The other major reason is that the formulation of programs by eleven governments must surely be more cumbersome, inflexible and long drawn out than program formulation by one government. There is also the democratic objection to the formulation of programs by federal-provincial conferences which would reduce the powers of the House of Commons and make it difficult to fix the responsibility for error or incompetence upon a single elected body.

None of this reasoning precludes the desirability of advance notice to the provinces of the broad course of action intended by the federal government - if the exigencies of timing permit.

Closely related to the problem of fluctuations in economic activity is the problem of seasonal unemployment. The three main ways by which the federal government has sought to alleviate the hardship created by the seasonality of employment have been:

- (a) by unemployment insurance - which required a constitutional amendment;
 - (b) by subsidies to private parties, such as the \$500 for residential housing construction undertaken during the winter; and,
 - (c) by the shared-cost grants for municipal winter works programmes.
- Obviously, since the provinces and municipalities are the big spenders on public works, the federal form of government makes the last mentioned programs cumbersome and complicated.

Allusion has been made to the possibility that the existing division of functions might impose obstacles in the way of a provincial government seeking to realise certain aspirations. Since the war, however, matters have been mainly the other way round. It has been the federal government which has repeatedly found that it has had to work through the provinces to achieve its economic objectives.

2. Monetary Policy

Much of the reasoning followed with respect to fiscal policy applies to monetary policy - with the added complication that the Bank of Canada possesses a broad measure of independence of action. Provincial governments are not disposed to protest about monetary ease but they have been known to complain about monetary restraints on two grounds. They may allege that the Bank's policy is mistaken, i.e. that monetary restraint is inappropriate to the economic conditions of the country as a whole. Or, they may grant that monetary constraints are appropriate for most of the country but contend that they harm some provinces in which unemployment rather than inflation is the main problem. As mentioned in the previous chapter, one is at a loss to know how the latter legitimate complaint can be met. So long as there is a single currency, it is not possible to have high interest rates in one province and low rates in another at the same time. This is another matter which clearly warrants a study by itself and in that study it could be pointed out that the entire structure of our banking and other financial institutions could be changed so that credit rationing would be effected not by a general set of interest rates confronting all classes of borrowers but rather by selective credit controls by which different classes of borrowers obtained credit on different terms.

The creation of the municipal loan fund presumably indicates a realisation on the part of the federal authorities that the 'non-selective' monetary restraints of the central bank are actually selective in the sense that the restraints are felt acutely by some classes of borrowers and hardly at all by others. The loan fund is the latest in

a series of departures from the 'free market' allocation of loan funds, of which the Industrial Development Bank and the Central Mortgage and Housing Corporation are other examples. It is noteworthy, however, that the disagreements between the federal and provincial governments which occurred when the loan fund was first proposed, did not reflect an inherent conflict of interests, (unless the administration of the program is itself put down as a federal objective.) The disagreement arose from the desire of the provincial governments that the federal authorities not deal directly with their municipalities - a concern which has been in evidence on other occasions. The resolution of the disagreements presumably indicates that the federal objectives could be realised in a manner acceptable to the provinces. This particular episode in the relations between the two levels of government is one of several which has prompted us to suggest that whenever the federal government wants programs to be adopted concerning which the provinces possess the power for independent action, an harmonious outcome is most likely to occur if the federal government recognises co-jurisdiction so that the two levels of government jointly formulate policy by jointly developing the program - rather than the federal government deciding upon a program and then seeking to persuade the provincial governments to accept it.

Let us next engage in a speculation. Suppose it were successfully contended that monetary controls affected the provincial governments' operations so decisively that they must have a voice in policy formulation. For example, we might imagine that the Board of Governors of the Bank of Canada were reconstituted to be composed of representatives of the federal and ten provincial governments and their powers

were increased, at the expense of those of the Governor, so that he had to report to them and obtain clearance for his actions each month. Would this be a feasible arrangement? One would be venturing upon uncertain ground to express a definite opinion but it may be speculated that the feasibility of this arrangement would depend greatly upon what the members of the Board conceived their function to be. If, in the main, they regarded themselves as representatives of the interest of the country as a whole and played the mainly passive role of receiving the periodic accounts of the Governor's stewardship and directing him to change his policies only on the presumably rare occasions when they were willing, in effect, to express a want of confidence in his judgment, one can speculate that matters would not be greatly changed from what they now are. Opinions would no doubt differ whether performance would likely be improved or reduced. On the other hand, if each government representative withheld acceptance of the periodic reports of operations until he had reported back to his Prime Minister and received instructions concerning how to represent the federal or provincial interest, one can foresee conflicts which might end in a deadlock unless there were carefully formulated conventions of majority rule with none possessing a veto power. For example, a provincial prime minister could scarcely be expected to leave himself open to the allegation by the press or a political opponent that he had agreed to monetary restraints which increased unemployment in his province.

This reasoning leads logically to the question: do the provinces require a voice in monetary policy formulation as a necessary condition of the realisation of their aspirations and those of their citizens? It might be said, that as a matter of form and appearance -

which may sometimes be very important - they may do; that is, a voice in monetary management may become an end in itself. In the extreme, one or more provincial governments might decide that nothing less than equal status with the federal government with regard to a number of functions is acceptable. Otherwise, it is difficult to imagine any way in which a provincial voice in monetary management is a necessary condition for the realisation of provincial policies and programs. It is difficult to think of a provincial program which cannot be realised without this power. If a fully specified alternative to the policies and mode of operation and, indeed, to the operation of the capital markets, existed and were pressed upon the federal government by one or more provincial governments, it would seem appropriate that the federal government not stand on its constitutional prerogatives but rather propose some method of joint deliberation by which the merits of proposed changes could be determined.

This discussion leads naturally to the related problem of the creation by provincial governments of financial institutions designed to facilitate provincial government programs to accelerate economic growth. This particular problem had best be left aside, however, for want of information. Going on general information only, it is not clear what problems would be created if a provincial government had some financial interest in or wholly owned a chartered bank. Nor is it clear what provincial economic objectives cannot be realised without such an instrumentality. It is possible, of course, that the desire for such an institution might be one part of a series of measures inspired by the desire to foster a provincial sense of identity which took

over the national identity or from a provincial government's conviction that the primary political unit was the province and that its duty required that it build up the provincial and denigrate the federal power. Such political phenomena lie outside our terms of reference.

3. Other Matters in Which Major Conflicts of Interest are not Apparent

One of the techniques of co-ordination listed above was the division of labour which results from a rigorous definition of the spheres of jurisdiction of the federal and provincial governments. But some overlapping of jurisdiction cannot be avoided and sometimes disputes occur which indicate that neither consultations in any of its meanings nor what we have called the recognition of co-jurisdiction, is a panacea. The development of international waterways and the export of electric power are examples. Surely these difficulties, among others, indicate that the federal form of government would not be chosen, de novo, for any inherent advantages it might possess but only because nothing better is politically possible.

4. Problems of Regional Economic Development

All the provincial governments to greater or less degree and the federal government are currently concerned with regional economic development. But the programs developed so far are a mere beginning as compared to those in many other countries. Two problems appear to be unresolved: the potentiality for conflict between provincial programs and the roles to be played by the provincial and federal governments.

Since the standard technique for attracting industry to regions where they would not otherwise locate consists of subsidies - though in a great variety of forms - the potentiality of conflict is apparent. The provincial governments might fall into a competitive race, the one trying to outbid the other, to the advantage of none. In the past, tax concessions offered by municipalities proved very expensive in some provinces, with little evident accomplishment. It would seem desirable therefore that rules of approved behaviour be formulated and accepted by all provinces to obtain the maximum effect for the money expended and to allow the regions which stand in the greatest need of more industry to implement programs which are not negated by those of regions where the need for more industry is less pressing.

Accordingly, what is mainly needed is not agreement concerning the inducements which it is permissible to offer but rather the regions or districts of the various provinces to which industry is to be attracted. And the approach used by the federal government in some of its incentive programs is not appropriate. It may be administratively convenient and apparently neutral to define a region of economic distress as any city, town or conurbation in which unemployment has exceeded a chosen percentage of the labor force for a specified length of time.

The objection to this approach is that it identifies the region of economic distress but not the localities where the chances of fostering growth are promising. Given that one of the two sets of measures for coping with chronic unemployment and underemployment consists of moving industry to where the unemployed labor is located (the other set of measures being designed to encourage the unemployed labor to move to areas of labor shortage and fast economic growth) it is often not possible or is prohibitively expensive to foster growth in the particular locality e.g. Western New Brunswick. The more promising approach is to identify centres of potential growth within the regions of economic distress. For example, since the prospects of stimulating growth in Western New Brunswick seem dim indeed, but a process of agglomeration could doubtless be stimulated in the Saint John conurbation, the most promising approach would be to identify metropolitan Saint John as a potential growth centre and offer incentives to attract industry to locate anywhere in the province at sites of their own choosing, on the expectation that most would select the Saint John area.

No doubt two objections would be raised to this procedure. First, New Brunswick residents would protest that industry should be moved into the very town where the redundant labor is located. One can think of several reasons why this would be the happiest solution; but it is assumed that it is either not possible or prohibitively expensive. The other difficulty is that there would be very large areas of the country within which no subsidy for the attraction of industry would be permissible. There might be towns within 200 miles of Toronto, for example, which might be identified as regions of economic distress. But many growth centres already exist fairly

close at hand, to which the redundant labor could move. Accordingly, if the necessity for short-distance mobility is accepted, possibly all of Southern Ontario or even all of Ontario except for the Lakehead and one or two other points, would be excluded from the areas of permissible incentives. Similarly, perhaps some entire provinces might be excluded, namely, Prince Edward Island, Alberta and British Columbia. It is doubtful that these provinces would be willing to accept binding rules of behaviour if they interfered with whatever plans they might have for accelerating the rate of growth of their province as a whole or of altering the structure of their industry. For this reason, the devising of ground rules of permissible action would not be a simple matter. It would call for an ambitious program of policy formulation jointly by all the eleven interested governments. And one of the first matters to be resolved would be the 'mix' between the attraction of industry to regions of inadequate growth and the movement of labor out of these regions, across provincial boundaries, to areas of fast growth. The slow growth provinces would likely want a maximum of the first alternative and the fast growth provinces and perhaps also the federal government, a maximum of the second.

If such a comprehensive program of joint policy formulation were undertaken, it would be necessary, of course, that a division of labor between the federal and provincial governments be agreed, and this might prove difficult. It could be expected that some provinces would want the function of planning for balanced growth to be primarily a provincial task, with the federal government standing by to act as a catalyst for agreement to prevent conflict between the various provincial endeavours and to provide funds and technical assistance for

at least the less wealthy provinces. This would require a reversal of form by the federal government and opinions would doubtless differ concerning whether the arrangement would be optimal. The opposite arrangement of the federal government being the prime mover but developing the details of programs in consultation with the affected province, might not be acceptable to some provinces. And any in-between arrangement would likely maximize the likelihood of controversy, and the likelihood that the operation of programs would be stalled by the breakdown of some parts of the administrative machinery.

It can be argued that the province must be the prime mover in economic planning because the tasks and the objectives differ from province to province - which in itself is not a decisive consideration - and that it is the provincial governments which are sympathetic to and, even more to the point, which devise the objectives - which may be a decisive consideration. Also, provincial initiative in planning is required because provincial instrumentalities may play a vital role in the implementation of the plans. At a minimum, the terms on which natural resources owned by the Crown in the right of the provinces are either leased or sold, must be brought into harmony with the economic development plan and perhaps made to play an integral role. Also, provincial governments will probably make increasing use of crown corporations to achieve their economic policy objectives. The projected Quebec steel mill is a case in point.

Since the provinces are becoming increasingly activist and dirigist, it may be assumed that the federal government has in fact already been elbowed into a secondary role with the exception of providing technical and financial aid to the least wealthy provinces

and developing programs primarily for their benefit. And it can be argued that the federal government has been remiss in not using consultation - let alone recognising co-jurisdiction - to a greater extent in the performance of these functions.

Accordingly, it may be speculated that a potential, serious conflict, between the federal and some provincial governments is already in the making. As development programs go forward, a province may find that tariff measures could perform a useful function. It may be objected that a tariff is a form of subsidy hence whatever a tariff can do, an alternative form of subsidy can also do. However, the incidence of the cost of one form of subsidy differs from that of another. The cost of a tariff may be spread over the country while the cost of a continuing cash subsidy would fall upon the taxpayers of the province. The difficulties of divided jurisdiction could become acute.

This potential problem relating to tariffs is additional to the conflict of interests which has already received some public mention. In lieu of a provincial voice in tariff policy it has been suggested that, when a province suffers from the granting by Canada of a concession to other countries, that province should be compensated by concessions won from other countries. Surely such a constraint upon tariff negotiations would freeze the Canadian tariff into its present form.

The potentiality of conflict over tariff policy is alarming because the interests of the various regions are often inherently incompatible. It is no accident that tariff matters have given rise to some of the bitterest antagonisms between regions in federal countries.

One cannot therefore be sanguine that provincial government participation in tariff matters would be conducive to harmony. For example, if representatives of the provinces should be brought together to bargain among themselves concerning the bargaining position which the federal government should adopt, who would argue the feasibility of the procedure? It seems self-evident that the only workable procedure is that the federal government be governed by the rule that the interests of each person, no matter where he lives in the country, should have equal weight; and that action be taken in tariff and other matters whenever the gains outweigh the losses. Even consultation between the federal and each of the provincial governments prior to tariff negotiations poses difficulties. If the concessions granted by Canada to other countries were to be substantial, they would inevitably cause some unemployment in some regions at least for a time. If consulted, the premier of the adversely affected province would be constrained to protest since he is regarded as the custodian of the region's interest. Similarly, if the concessions were granted to other countries despite his protests, he might be constrained to attack the federal government for doing so. His political position might require it.

Finally, by stretching a point, there may be listed as a problem of co-ordination, the setting of priorities covering both federal and provincial programs and the concomitant division of revenues to enable the agreed priorities to be realised. A thorough co-jurisdiction approach to this co-ordination problem would require that policy decisions be jointly arrived at by the two levels of government not only with respect to expenditure programs and the division of revenue sources but also with respect to the tax structure. Otherwise some revenue fields may be

underutilised and others overutilised. Such an overall approach is presumably being followed by the Tax Structure Committee of the Federal-Provincial Conference.

In such a procedure, one would expect the matter which would be of crucial and pivotal importance would be the criteria by which the allocation of expenditure functions between the two government levels was to be determined. And one would expect the future unity of the nation to be greatly affected by the retention or surrender of the federal government's right of initiative to introduce new nation-wide expenditure programs which violate the constitutional division of functions. If the functions of compelling interest to the public - social welfare, education, economic development and coping with the social problems of unemployment and underemployment which economic change creates - fall to the provinces even though it is accepted that the federal government might still act as an overall co-ordinator, it would be difficult to be sanguine about an increased sense of unity within the country. Economic problems can be met and economic policies implemented but it is undeniable that the machinery is immensely more complex and cumbersome in a federal country than it is in one with a unitary government. On the other hand, our discussion has uncovered remarkably few issues in which inherent conflicts of interest either between the federal and provincial governments or between different provinces are so severe that they are not amenable to resolution assuming that all parties so desire and provided that regional interests are not made paramount, but rather, are submerged in the preoccupation with common interests. On the other hand, if any of the governments adopt the enlargement of their spheres of action as an end in itself, one finds it difficult to be sanguine about the future.

One can always hypothesize procedures whereby co-ordination could be effected, harmony made to prevail, and the regions of economic distress eliminated. But this would be no more than an exercise in describing the most favourable outcome possible. To expect that it would happen is quite another matter. Each time this writer ponders the problems encountered by the Canadian federation he finds himself forced to the conclusion that federalism is an inherently defective form of government which not only creates technical difficulties which would not otherwise be present but is also, by its very nature, inimical to national unity by giving rise to divisive issues which would not otherwise occur. The very machinery of federalism itself creates centrifugal forces. Accordingly, rather than exploring the ways by which problems created by a decentralisation of functions could be overcome, I find myself wishing that we were exploring the appropriateness of the governmental structure of the United Kingdom to Canada, including the relationship of the government of Northern Ireland to the government at Westminster.

